ESBG response to EBA consultation on the review of its SREP, IRRBB and Stress Test Guidelines (Pillar 2 framework)

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Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA review of the Pillar 2 Framework. We would like to share with you the following reflections that we hope will be taken into account by the EBA.

The comments below on SREP, IRRBB management and Stress test draft Guidelines reflect the structure of the questionnaire in the EBA documents (namely for SREP: 6 questions; for IRRBB management: 16 questions and for Stress test: 1 question). Additional issues which are not covered by the questions are added after the questions section.

In addition, we would like to recall that CRR, CRD, CRRD, SRMS and BRRD (RRM package) is currently under review. Due to the fact that a final text has not been agreed yet, ESBG believes that additional comments on some parts of the revised EBA Guidelines might be required depending on the outcome of the ongoing negotiations.

A. Consultation on common procedures and methodologies for SREP

Question 1: What are the respondents’ views on the overall amendments and clarifications added to the revised guidelines?

ESBG believes that overall the amendments are going in the right direction, although further alignments and clarifications will be necessary. The revised guidelines confirm many practices already applied and develop concepts where there have been no clear guidelines so far.

Question 2: What are the respondents’ views regarding ‘the interaction between SREP and other supervisory processes, in particular assessment of recovery plans’ provided in the ‘Background and rationale’ section?

The connections between the risk management framework, the recovery and the resolution framework are described in a very general manner in the draft EBA SREP Guideline, especially with regards to the interconnections between the expected threshold levels. However, we believe that this may hinder the establishment of a consistent structure for resolution, recovery and risk thresholds, which meets all of the requirements set out in the EBA SREP Guideline as well as is in line with the purpose of the elements according to the CRD and the CRR. Based on the current proposal of the EBA SREP Guideline, an institution may be subject to requirements more stringent than those laid down in CRD.

In particular, this could lead to a limitation in access to the buffers and would further result in an earlier distribution limit (see details in the response to Question 4). The section in its current form leaves room for different interpretations.

Against this backdrop, ESBG would appreciate a more explicit explanation on the interaction between supervisory and early intervention taking into account the consistency requirements between the ICAAP/SREP, the Pillar 2 guidance (P2G), the recovery requirements and the early intervention (see response to question 4 below). At the same time, proportionality aspects should be taken into account. A detailed comparison should not constitute a mandatory requirement for the supervision of smaller and medium-sized institutions.

Question 3: What are the respondents’ views on how the assessment of internal governance and institution-wide controls has been aligned with the revised EBA Guidelines on internal governance (Section 5)?
In ESBG’s opinion, the revised guideline, similarly to other existing EBA guidelines, imposes a wide range of operative tasks to the management body. Involving the management body as a requirement and an assessment factor in practically all areas of a bank on a very (too) detailed level. We would propose to consider the fact that the more the management body is required to be involved in the details, the less time its members have to focus on their original tasks: on the strategy and on the business model. In our view, the governance structure of the institution has to ensure that the decisions of the management body are implemented and monitored properly. Therefore, we would appreciate a balanced approach here.

Regarding paragraph 92.a, the actual sentence “arrangements aimed at ensuring that the individual and collective suitability of the management body and key function holders are implemented and carried out (…)” should be replaced, in our view, by the following one: “arrangements aimed at ensuring that the individual and collective suitability of the management body and the individual suitability of key function holders are implemented and carried out (…)”. The actual wording isn’t consistent with the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders as the collective suitability applies exclusively to the management body.

Finally, as a general comment to Title V, ESBG would welcome an introductory paragraph recognizing that regarding the management body the Guide takes into account all existing board structures and that the terms “management body in its management function” and “management body in its supervisory function” are used without referring to any specific governance structure. This clarification is in other Guidelines such as the EBA Guidelines on Internal Governance or the Joint EBA and ESMA Guidelines on the assessment of the suitability (paragraphs 10 and 11).

Question 4: What are the respondents’ views on the provisions of the newly introduced Pillar 2 Capital Guidance?

In ESBG’s opinion, some of these provisions need to be further clarified, especially in terms of:

- Consistency with Pillar 2 requirement (P2R): The approach according to which the P2G can or should “cover certain aspects of the same risks addressed by P2R” (paragraph 393 and other paragraphs of the draft EBA GL SREP) is questionable. In line with its purpose as prescribed by Article 104 of the CRD IV, the P2R shall cover all material risks run by the institution due to its own activities and not covered under other legal requirements of the CRR/CRD (Pillar 1, buffers, large exposure, and leverage ratio). These same risks shall not be reflected also in other requirements or guidance. This would increase the non-transparency of the P2G and the regulatory capital requirements;

- The relationship between P2G and limitations on distributions: Under the draft EBA SREP Guideline, a potential P2G breach does not trigger automatic restrictions on distributions. However, in case of breach of the P2G level, the competent authority has the power to require an updated capital plan and if necessary, to take any supervisory measures, which means that it is possible, that the competent authority will restrict the distributions before reaching the combined buffer requirement (CBR) level. In our view, this creates uncertainties and does not ensure transparency of the requirements – neither for the institution itself, nor for the investors;

- The exact mechanics as to how buffer offsetting according to paragraph 397 is supposed to work: It is unclear to what extent and based on which criteria P2G should/could be offset against the counter-cyclical buffer and the systemic risk buffer (SRB), whose current application in the EU/EEA seems to be a main driver of a still fragmented implementation of prudential requirements across Europe as the framework of the SRB is still very flexible. There are currently jurisdictions in which the SRB is activated to cover macroprudential risks, such as elevated levels of housing prices and the household debt burden, which potentially overlap with the P2G. Consequently, when the SRB is set
to cover macroeconomic risks and do not reflect risks an institution poses to the wider system, the competent authority should also offset the P2G against the SRB;

- Determining the levels of P2R and P2G: ESBG believes that the supervisory approaches in terms of determining the levels of P2R and P2G, as well as the scoring rules, are not sufficiently transparent for banks, which is an obstacle to efficient capital planning. We would suggest explaining the exact methodology, so that banks are able to manage their P2R and P2G expectations in a forward-looking manner;

- Implementation deadline: If the P2G is introduced in the EBA SREP Guideline, the introduction should be conditional upon implementation of the CRD IV instead of using a fix deadline of 01/01/2019. In the CRD IV there is no guidance mentioned, and there is no option to implement one. In our view, the P2G part – and any other conditional part on the final CRDV - should come into force upon implementation of the CRD V and it has to be ensured that the wording should be in line with the final wording of the CRD V;

- Required capital composition of P2G: The requirement in paragraph 399 and Annex 5 for P2G to be fully met by CET1 is inappropriate. Article 104b of the Commission’s draft of CRD V stipulates the use of own funds and – in contrast to P2R in accordance with Article 104a (4) – no Tier 1 sub-ratios are specified. In ESBG’s view, the EBA does not have a mandate to specify a tightening of the expected Level 1 requirements by means of guidelines. Demanding the use of CET1 only would mean an inappropriate restriction, especially because other components of own funds can be used for loss absorption as well. The P2G notified by the supervisor constitutes an expectation as regards to capital adequacy that does not have to be met by the institution at all times;

- Reflecting stress test results: Consideration of stress test results for setting the P2G should have strong attention on the scenario used as a basis for the stress test. This refers to both, probability of occurrence and plausibility of the underlying scenario. Stress test results should be explicitly or implicitly weighted with the scenario occurrence probability to avoid unreasonable capital requirements derived from extremely low probability scenarios. In addition, a forward looking view (including explicit assumptions on the monetary policy) should be key in the assessment of scenario plausibility compared to mechanical extrapolation of historical developments;

- It is important to specify how the results of supervisory stress tests are used to determine P2G and provide more detailed, quantitative explanations on the inclusion of stress test results in P2G, e.g. concerning the set of risk factors and the calibration of such factors. This is essential for the harmonisation of supervisory stress test scenarios across jurisdictions. In ESBG’s view, significant differences between the calibration of NCAs stress tests will on the other hand cause a fragmented setting of the P2G throughout the EU/EEA and thus be an additional source of regulatory divergences;

- Supervisory stress test methodology (namely EBA Stress Test) prescribes a unique methodology to be used by all the institutions in a sample. As methodology is unique for the whole sample, it inevitably adapts a set of simplifying assumptions which, in some institutions' case, might introduce significant distortions to economic reality. If there is potential for significant impact of such distortions on the stress results of certain institutions, ESBG thinks that their feedback in this respect should be considered in the process of setting P2G;

- Paragraph 569: ESBG would like to ask for a clarification in terms of purpose and background.
Question 5: What are the respondents’ views regarding disclosure of P2G (paragraph 403), keeping in mind the criteria for insider information?

Given that some institutions may consider this information relevant for their investors, we believe it should up to the institution to decide if it publishes it or not.

Also, we believe it would be helpful if supervisors communicated, in the course of SREP, the relative position of the P2G within the peer group, which can be done anonymously.

Question 6: What are the respondents’ views on the introduction of supervisory stress testing in the revised guidelines (Section 12)?

In ESBG’s view, it is unclear whether only the supervisory stress tests or internal ICAAP stress tests will be relevant for the setting of P2G. While paragraph 388 refers solely to the results of the adverse scenario of relevant supervisory stress tests, paragraph 395 states that when determining the size of P2G, “the outcome of reliable ICAAP stress test to assess severity of the results” should also be considered. More precise rules on the basis for P2G setting are welcome.

The draft EBA SREP Guideline states that “competent authorities should establish an effective programme for supervisory stress testing”. It should be recognized by the competent authorities that supervisory stress tests might be associated with significant pressure on the resources of participating institutions (especially in cases when new methodology is introduced). In this respect, we believe that supervisory stress testing programme should be transparently disclosed to institutions in a timely and comprehensive manner. Frequent changes in the scope and content of supervisory stress test methodologies result in a significant consumption of resources for institutions. For this reason, supervisory stress test methodologies should be stabilised over time and consistently applied across different supervisory stress testing exercises.

If opted for specific supervisory stress tests covering different categories of institutions, both the complexity and the business model type, should be considered in a stress test design. ESBG believes that less complex institutions should be stressed by adequately simplified versions of a stress test. When it comes to the business model, specific focus should be on the portfolios associated with the particular business model, requiring lower granularity for the non-focus areas.

Additional comments:

1. Paragraph 89: Internal Governance

The recovery plan is included on the way that only “consistency of recovery planning” should be assessed as part of the governance and institution-wide controls. ESBG would like to stress that this, however, is only one aspect, while other aspects – credibility, etc. – are not considered herein. Although in other paragraphs of the draft EBA Guidelines, reflecting the BRRD requirements, the scope of the assessment is much wider (e.g. section 5.9, paragraph 132, etc.).

2. Section 7.7: Meeting requirements in stressed conditions

The EBA guidelines cover the new capital requirements structure distinguishing between Pillar 2 requirements and guidance, introduced in the Commission proposal on the revision of the capital requirements framework. As regards this distinction, ESBG would like to highlight two issues related to the likely re-designation of current Pillar 2 capital add-ons. The Council has proposed to amend the Commission proposal so as to facilitate the application of the systemic risk buffer by removing the
requirements for supervisors to request permission from the Commission to raise the buffer rate from 3% to 5%. Competent authorities could thus easily replace current add-ons based on systemic risks with higher systemic risk buffers.

Currently, competent authorities commonly address macro-prudential risks not just by using the actual macro-prudential tools aimed at addressing risks posed by an institution to the financial system, but also by using Pillar 2 capital add-ons. This is especially true as regards systemic risks. Following the new rules, Pillar 2 capital add-ons will likely be confined to a purely micro-prudential perspective. Once the revised framework is in place, certain new designations of the current add-on elements would affect the calibration of the maximum distributable amount (MDA) and lead to restrictions in cases where they may not be appropriate.

In ESBG’s view, the defined scope of Pillar 2 guidance should leave sufficient room for competent authorities to apply supervisory judgement when calibrating Pillar 2 requirements. According to the proposed guidelines, the setting of Pillar 2 guidance would be based mainly on the results of supervisory stress tests (Section 7.7). However, several add-ons currently applied by competent authorities are non-related to factors that may be covered by stress tests, meaning that such add-ons could be re-designated into requirements, not guidance. Following the capital requirements structure proposed in the guidelines, which do not give competent authorities the current flexibility of applying requirements that may be capitalised with different types and proportions of capital, the re-designation will also increase capitalisation costs.

Firstly, the re-designation of systemic risk add-ons to the systemic risk buffer would impact the MDA calculation of the:

- When assessing the bank’s financial standing, stability and ability to run a sound banking operation as well as its ability to make distributions, investors also take into account the expected MDA threshold and restrictions. Because of the perceived risk for non-payment of dividends and coupons following MDA-restrictions, it may complicate the valuation and marketing of AT1 instruments as well as of ordinary shares, for banks facing higher capital requirements due to an extensively applied buffer regime. In our view, this could risk destabilising the financing of the institution;

- As for AT1 instruments, this may also complicate the valuation of MREL instruments for institutions subject to higher capital requirements in the form of high buffers connected to MDA restrictions;

- EU banks which are relatively better capitalized due to high systemic risk add-ons face a disadvantage in the funding market compared to EU banks with less capital – a contradictory and surely unintended consequence;

- Since a systemic risk buffer requirement is only applied in the European market, including them when calculating the automatic MDA restrictions would also risk placing European institutions at a disadvantage compared to their global peers.
ESBG believes that measures applied should be appropriate and proportional to the institution’s situation (including macro-economic factors) at a specific point in time. The competent authority is best equipped for carrying out holistic assessments taking into account the situation of the institution and the financial system as a whole. Without adequate judgment by the supervisory authority, MDA restrictions could have untimely and far-reaching consequences for the financing and stability of the institution, which could in turn hurt the financial system as a whole in that particular EU jurisdiction.

Hence, instead of automaticity, ESBG would prefer that it be left to the judgement of the supervisory authority to decide whether further MDA restrictions are necessary in such cases; if the supervisory authority finds that certain systemic risks warrant requirements are higher than normal, it is important that it be allowed to apply these requirements without triggering automatic MDA restrictions. The objectives of the framework would be better fulfilled if triggering MDA restrictions were a concern of supervisory judgment based on actual scenarios and risks.

In addition, the re-designation of Pillar 2 add-on elements would also impact the required capital composition:

The SREP guideline proposed by the EBA would change the minimum required capitalisation of elements now imposed in accordance with the current add-on regime. In ESBG’s view, the proposed capital requirements structure does not give authorities the current flexibility of applying requirements that may be capitalised with types of capital other than CET1. The re-designation of current Pillar 2 add-on elements will thus increase capitalisation costs.

Some competent authorities currently allow Pillar 2 requirements and add-ons to be capitalised with AT 1 and T2 instruments in the same proportion as is the case for Pillar 1 requirements (in the case of the Pillar 2 requirement, excluding the countercyclical buffer). In its draft guidelines, the EBA instead proposes that the Pillar 2 requirement – at minimum – be capitalised in standardised proportions of 56 % CET1, 19 % AT 1 and 25 % T2. Pillar 2 guidance would, according to the draft guidelines, be capitalised with CET1 only.

3. Section 7.9: Communication of prudential requirements

ESBG is concerned about the proposal of the draft EBA Guidelines stating that the combined buffer requirement (and the overall capital requirements “OCR”) shall be communicated together (in the Joint Decision?). Due to the fact that the buffers are partially macroprudential tools in the hands of the macroprudential authorities, in case of cross-border groups the consolidating authority is simply not able to calculate the combined buffer requirements (CBR) (see the institution specific countercyclical capital buffer for example) and especially not for a year ahead. Considering the variable elements in the CBR, which can change over time (even the capital conservation buffer can be increased over 2.5% pursuant to Article 458 CRR), in our view, it is not a good idea to fix the CBR for a full year ahead (in the Joint Decision?). It is also unclear as to who should make this communication in case of a cross-border group:

- The macroprudential authority of the consolidating institution can communicate the actual combined buffer requirement on EU consolidated level, but does not know what the CBR over the next year or in the subsidiaries will be, although this would be relevant for the SREP/Joint Decision (valid for one year). Additionally it has no power to communicate the P2R and the P2G;

- The consolidating supervisor can and has the power to communicate the P2R and P2G, but has no information and consequently no power to communicate the CBR.
Here we appreciate the ECB practice, clarifying the Pillar1 and the Pillar2 requirements in the Joint Decision and adding that the institution “is hereby reminded that it is also subject to the overall capital requirement (OCR), as that ratio is defined in section 1.2 of Guidelines EBA/GL/2014/13, which includes, in addition to the TSCR, the combined buffer requirement as defined in point (6) of Article 128 of Directive 2013/36/EU, to the extent it is legally applicable”. Therefore, we would propose to implement this approach in the draft EBA Guidelines on SREP.


With the amendments, very extensive powers shall be given to the supervisors to change even the banks’ business decisions– it is not limited in the text, what sort of decisions the supervisor can make. The institution shall apply those, even if they go against the business strategy or any business, market or other logic – although the institution is not in resolution. In this regard, ESBG does not agree with letting business decisions be overruled by a supervisory authority. We recommend at least clarifying those specifications.

5. Paragraph 561: College of supervisors

We would propose to add the “methodologies and approaches used by the different authorities in the college” which should be discussed and coordinated with the framework of colleges of supervisors. These are very different in many cases, sometimes even contradictory. In case of a cross-border group this causes difficulties and requires many more efforts. ESBG would appreciate a consensus – or at least a mutual understanding between the supervisors – of the different approaches and methodologies in the supervisory college.

B. Consultation on the management of IRRBB

Question 1: Are the definitions sufficiently clear? If not, please provide concrete suggestions and justify your answer.

ESBG would like to suggest rephrasing the following definitions:

- Gap Risk:
  It is defined as “Risk resulting from the term structure of interest rate sensitive instruments that arises from differences in the timing of their rate changes, covering changes to the term structure of interest rates occurring consistently across the yield curve (parallel risk) or differentially by period (non-parallel risk).” We think that this type of risk could be defined more clearly as “Yield curve risk” instead of “Gap Risk”. In addition, we think that its definition could be simplified as follows: “Risk arising from the timing mismatch in the repricing/redemptions of assets, liabilities and off-balance sheet positions. As a consequence, changes in their value or net interest margin arise due to an absolute (parallel risk) or relative (non-parallel risk) variation of the yield curve.”

- Basis Risk:
  It is defined as “Risk arising from the impact of relative changes in interest rates on interest rate sensitive instruments that have similar tenors but are priced using different interest rate indices. It arises from the imperfect correlation in the adjustment of the rates earned and paid on different interest rate sensitive instruments with otherwise similar rate change characteristics.” We think that the definition could be simplified as follows: “Risk arising from the imperfect correlation in the adjustment of the rates earned and paid on different interest rate sensitive instruments with similar rate change characteristics.” In addition EBA should list the type of basis risks that are expected to be
covered by institutions (for example, market rates vs administered risk, market rates vs central bank risks, and so on).

- Credit spread risk from non-trading book activities (CSRBB):
  CSRBB is defined as “any kind of spread risk of interest rate sensitive instruments that is not IRRBB or credit risk.” From our point of view, this definition is too vague. Based on the information related to this risk provided by the Annex II of BCBS standards on IRRBB, we propose the following definition: “Risk arising from potential variation of the value of a group of credit-risky instruments, caused by an adjustment in the market perception about their credit quality, either because of changes to expected default levels (market credit spread) or because of changes to market liquidity (market liquidity spread).” In accordance with this definition, CSRBB can be used to measure the impact of market liquidity/market credit spread on the balance sheet. From our point of view, IRRBB should be exclusively related to pure changes in interest rates, in order to avoid risks double counting measurement. On the other hand, we are aware that CSRBB is a relevant risk that institutions should oversee. For this reason we propose monitoring CSRBB as a balance sheet risk measure apart from IRRBB, and only related to tradable instruments.

In addition, the EBA could maybe clarify the following aspects relating to CSRBB:
- What is the purpose?
- Which spreads should be included?
- What is the scope of application for the measure according to IFRS9 Accounting treatments? Does it only apply to assets or liabilities as well?
- How to define risk measures? Spread sensitivities or VaR?
- Scenario assumptions: going-concern, gone-concern?
- What kind of limits should be imposed?

**Question 2: Are the guidelines in section 4.1. regarding the general provisions sufficiently clear? If not, please provide concrete suggestions.**

**Paragraph 18:**
This paragraph insists on the idea that “institutions should identify, monitor and measure their CSRBB exposures and ensure that CSRBB is adequately controlled, if relevant for the risk profile of the institution”. In this regard, we think that references to CSRBB are very general once again. EBA should provide institutions with more guidelines on that. From our point of view, IRRBB should be exclusively related to pure changes in interest rates, in order to avoid risks double counting measurement. Nevertheless, we are aware that CSRBB is a relevant risk that institutions should oversee. For this reason ESBG would propose monitoring it as balance sheet risk measure apart from IRRBB and only related to tradable instruments.

In particular, in our view the EBA could be more specific when defining interest rate sensitive loan commitments that should be included in the IRRBB analysis:
- Could you specify if this only applies to either fix positions or variable positions or to both?
- Do we understand correctly that interest rate non-sensitive loan commitments (or close to it) can be treated as having zero-interest rate risk in as of date position of a bank?

**Question 3: Do you agree that cash flows from non-performing exposures (NPEs) should be net of provisions and treated as general interest rate sensitive instruments whose modelling should reflect expected cash flows and their timing for the purpose of EV and earnings measures? If not, please provide concrete suggestions and justify your answer.**
Yes, ESBG agrees with this statement. Cash flows from non-performing exposures (NPEs) should be net of provisions and treated as general interest rate sensitive instruments whose modelling should reflect expected cash flows both for EV and earning measures. Nevertheless, we think that EBA should provide a specific technical guidance on how NPEs should be treated within the supervisory outlier test in order to obtain comparable results across the industry. The timing of NPLs recovery could vary from one entity to another. In this sense, it would be appropriate to limit maximum timing of recovery.

**Question 4: Are the guidelines in section 4.2 regarding capital identification, calculation, and allocation sufficiently clear? If not, please provide concrete suggestions and justify your answer.**

In ESBG’s view, the guidelines are confusing in some points. Please find below our comments in relation to specific paragraphs:

- **Paragraph 23:**
  “Institutions should demonstrate that their internal capital is commensurate with the level of IRRBB, taking into account the impact on internal capital of potential changes in the economic value and future earnings resulting from changes in interest rates. Institutions are not expected to double count their internal capital for EV and earning measures.”. In ESBG’s opinion, this text seeks to suggest the calculation of two different economic capital measures: one based on economic value, another based on earnings. In this regard, we think this text should be replaced with the following one: “Institutions should demonstrate that their internal capital is commensurate with the level of future earnings. And for this purpose, entities should calculate the potential impact of changes both in economic value and in short-term earnings. Economic value analysis will allow entities to take into account the impact in capital of future retained earnings. On the other hand, short-term earnings analysis could show interest rate scenarios in which institutions will suffer short term losses that will required additional capital.”;

- **Paragraph 25:**
  “Institutions should not only rely on the supervisory assessments of capital adequacy for IRRBB nor on the outcome of the supervisory outlier test (see Section 4.5.), but should develop and use their own methodologies for capital allocation, based on their risk appetite, level of risk, and risk management policies. In determining the appropriate level of capital, institutions should consider both the amount and the quality of capital needed. ” It is not sufficiently clear how to assess capital adequacy connecting risk appetite concept that it is specified in paragraph 33. Economic Perspective is by definition long-term view of the risk and Earnings perspective is more adequate to assess short term risk, but not using the two perspectives for long and short term impact. Also, we believe it is worth highlighting that risk appetite is connected with risk, and capital adequacy is linked to losses. Therefore for capital adequacy calculation only negative impacts have to be considered;

- **Paragraph 26 (a):**
  “The size and tenor of internal limits on IRRBB exposures, and whether these limits are reached at the point of capital calculation.” In ESBG’s view, the EBA should provide clarifications in relation to these points. Institutions should allocate capital according to the current level of risk. RAF Limits are just an expression of institution risk appetite, not of capital allocation. Same concept used in previous comment.

**Question 5: Do you agree with the list of elements to be considered for the internal capital allocation in respect of IRRBB to earnings in paragraph 30? If not, please provide concrete suggestions. Please justify your answer.**
ESBG considers that derivatives instruments are always linked to the hedged instrument and cannot be seen as a separated item for internal capital measurement, because this is not the rationale of the hedge. Although we consider very important that these types of transactions be clearly defined and monitored.

**Question 6: Are the guidelines in section 4.3. regarding the governance sufficiently clear? If not, please provide concrete suggestions and justify your answer.**

In ESBG’s view, the guidelines need additional clarifications on certain aspects. Please find below our comments in relation to specific paragraphs.

- **Paragraph 33:**
  “The institution’s risk appetite for IRRBB should be expressed in terms of the maximum acceptable short-term and long-term impact of fluctuating interest rates on both earnings and economic value and should be reflected in limits.” Institutions usually apply different time horizons for assessing the impacts on earnings and on economic value. Traditionally, a runoff risk horizon is used to measure potential variation on economic value of equity. A shorter risk horizon – ranging from one to two years – is used to measure potential variations on earnings. In this sense, we would suggest replacing the text in paragraph 33 by the following one: “The institution’s risk appetite for IRRBB should be expressed in terms of the maximum acceptable impact of fluctuating interest rates on both earnings and economic value and should be reflected in limits. Institutions with significant exposures to gap risk, basis risk, or option risk should determine their risk appetite in relation to each of these material sub-types of IRRBB.”

- **Paragraph 33 / Paragraph 44 (d) & (e):**
  “Institutions with significant exposures to gap risk, basis risk, or option risk should determine their risk appetite in relation to each of these material sub-types of IRRBB.” “Depending on the nature of an institution’s activities and business model, sub-limits may also be identified for individual business units, portfolios, instrument types or specific instruments.” The level of detail of risk limits should reflect the characteristics of the institution’s holdings, including the various sources of the institution’s IRRBB exposures. Institutions with significant exposures to gap risk, basis risk or option risk should establish risk limits appropriate for these risks.” In relation to the definition of sub-limits due to gap risk, basis risk, or option risk, we believe the EBA should provide a specific guideline to institutions to ensure the comparison of results across the industry;

- **Paragraph 43(c) / Paragraph 44 (f):**
  “Institutions should particularly take into account the earnings impact related to embedded optionalties in fair value instruments under ongoing interest rate shocks and stress scenarios. Institutions should also take into account the impact on the profit and loss (P&L) accounts of hedging interest rate derivatives whose effectiveness may be hampered under certain interest rate changes.” “A dedicated set of risk limits should be developed to monitor the evolution of hedging strategies that rely on instruments such as derivatives, and to control market-to-market risks in instruments that are accounted for at market value.” This text is not clear. We understand that EBA actually refers to the application of specific limits to the prepayment risks exposure of hedged positions, as well as to the risk exposure due differences between the take-up of products pre-hedged, and expectations. In this context, prepayment risk refers to the risk of a hedged position’s loss of value that arises when the prepayment behaviour of customers is different than expected. This in turn leads to a reduction of the outstanding principal of assets or liabilities above their current hedges. In this sense, potential limits should be applied. But, in our view, they should be applied to the mismatch between the adjusted profile and the current hedge in order to minimize the Institution Risk Exposure. And not just to the hedges, as the EBA suggests. A loss of value could also occur due to the fact that the take-up of a product is different than expected. In this sense, we suggest EBA modify the text, clarifying that
these types of limits should be applied against the mismatch between institutions positions and their hedges;

- Paragraph 46(f):
  What exactly is meant under 'pipeline transaction'? Can the EBA, please, be more specific on characteristics of such transactions (defined or not defined in the contract, interest rate behaviour etc.).

**Question 7: Are the guidelines in section 4.4 regarding the measurement sufficiently clear? If not, please provide concrete suggestions and justify your answer.**

ESBG believes the EBA should provide more guidelines in relation to basis risk measurement (o institutions measure it based on historical data, should they have other assumptions?). In addition, the EBA should list the most common and material basis risks that should be taken into account by institutions.

Also, could the EBA please be more specific on how interest rate dependent cash flows, as mentioned in paragraph 89, are consistent with, for example, a limit of a five-year average repricing period for demand deposits? In which interest rate scenario should the limit be binding? Is the five-year limit defined on all NMDs or per segment, portfolio and/or product?

**Paragraph 106(a):**
The guideline defines core balances as balances on transaction accounts that are consistently kept in the customer account as distinct from balances that are drawn down regularly and then replaced. Is it intentional to define core on single account level? In our opinion, core of current accounts is formed by transactional money that remains in a bank or given portfolio, not on an account. We consider transfers between our own clients as part of the core money as volumes do not disappear from the bank. In EBA definition, however, such transactions would be considered as non-core. We argue that the definition of core money should be portfolio-level based and refer rather to stability of the money (probability to stay under almost any conditions) and probability to reprice.

**Question 8: Do you consider the comparison between EV metrics calculated using contractual terms for NMDs with the EV metrics calculated with behavioural modelled assumptions sensible and practical? Please justify your answer.**

With regard to this point, ESBG would just like to stress that to ensure a level playing field for European banks, discussion should evolve around the validity of assumptions and not the rationale for using (or not using) behavioural models.

**Question 9: Are the guidelines in section 4.5. regarding the supervisory outlier test sufficiently clear? If not, please provide concrete suggestions and justify your answer.**

We believe the EBA should clarify whether a maximum average maturity of five years should be applied to all deposits without specific repricing dates.

Also, the set-up of supervisory outlier tests does not include the inclusion requirement of interest rate sensitive loan commitments. Does it mean that for supervisory outlier shock, loan commitments should be considered as having a zero-interest rate risk?

In addition, could the EBA please be more specific regarding one risk-free yield curve per currency that should be used for the supervisory outlier test? In section 113 (n), it is defined that an appropriate general risk-free yield curve should be used. Should it be ON, 3M, 6M or an appropriate yield curve per given product?
Paragraph 113(o):
This paragraph sets constraints on repricing date for non-maturity deposits whereas point 17 (o) speaks about average maturity. Could the EBA please clarify what should be limited?

Question 10: Is proportionality adequately reflected in the guidelines, in particular in relation to the transitional period for SREP category 3 and 4 institutions and the frequency of calculation for the additional outlier test under paragraph 112?

In ESBG’s opinion, less complex institutions should be allowed to use simple and standardised stress tests with less frequent calculations and reporting.

Question 11: If relevant, do you manage interest rate risk arising from pension obligations and pension plans assets within the IRRBB framework or do you cover it within another risk category (e.g. within market risk separately from IRRBB, etc.)?

We consider that the risk exposure of such positions due to interest rate changes should be factored as IRRBB.

Question 12: Which treatment of commercial margins cash flows do you consider conceptually most correct in EV metric, when discounting with risk free rate curve: a) including commercial margins cash flows or b) excluding commercial margins cash flows? Please justify your answer.

ESBG considers margins part of the interest rate risk. For this reason, we think commercial margins should be considered for EVE calculation.

Question 14: Do you consider the level of the proposed linear lower bound as described in paragraph 113 (k) appropriate? If not, please provide concrete suggestions and justify your answer.

Could the EBA please be more specific regarding calibration of this lower bound, on which economic principles was it defined? In ESBG’s view, the proposed lower bound is too artificial. We assume that the lowest level of the central bank rate, for example, in the last five to ten years, would be a better floor representative.

Question 15: Do you consider the minimum threshold for material currencies included into the supervisory outlier test (5% for individual currency and minimum 90% of the total non-trading book assets or liabilities) sufficient to measure IRRBB in term of EVE? If not, please provide concrete suggestions and justify your answer.

Yes, ESBG agrees with this statement.

Question 16: When aggregating changes to EVE in the supervisory outlier test, does the disregarding of positive changes to EVE have a material impact on the calculation of the supervisory outlier test?

In ESBG’s opinion, the impact size depends on a number of factors, such as behavioural modelling and the absolute level of interest rates. However, for banks with a market leading position in their home markets, the ability to offset short-term risk in smaller interest rate market is sometimes limited. Disregarding positive changes would then have a material impact on the calculation. In our view, using historical correlations between interest rates in different currencies would be a prudent way to measure and manage risk. To use correlations in different time bands for every pair of currencies would further improve risk management. Also, diversification effects due to risk exposure to different currencies should be taken into account.
C. **Consultation on Guidelines on institution’s stress testing**

1. **General comments:**

ESBG appreciates the focus on proportionality and finds it important for this concept to be included in all aspects of the Guidelines. It is crucial that less complex institutions be stressed by an adequately simplified version of a stress test, and that the stress test methodologies reflect differences in size, complexity and business models. If a less complex institution has an existing stress test set-up that clearly covers the major risks in the institute, in our view, there should be scope for continuing these without further amendments.

2. **Paragraph 9: Anchor scenario**

Anchor scenario is defined in paragraph 9 (Point 14) as “a type of scenario usually designed by a competent authority to set the severity standard for a particular stress test...”. Although institutions could use this scenario as a severity benchmark for the development of own scenarios, the only comprehensive scenario is currently published for EBA Stress Test purposes. For this reason, ESBG is of the opinion that the text could benefit from a clear recommendation to the competent authorities to design and publish such scenarios. If considered as more appropriate, amendments could also be made to the Supervisory stress testing section of a new draft SREP Guideline.

3. **Paragraph 32 and 189: Appropriate frequency of a stress test**

Appropriate frequency of a stress test is a topic in paragraph 32 and is mentioned under Point d) of paragraph 189. While paragraph 32 clearly outlines the criteria to be used when determining appropriate stress test frequency, Article 189 sets the minimum frequency threshold, disregarding the criteria previously specified. Therefore, ESBG would recommend the following amendment of Article 189, Point d):

“ICAAP and ILAAP stress tests should cover the same forward-looking period as the institution’s ICAAP and ILAAP respectively, and be updated according to the frequency determined following the principles set in paragraph 32.”

4. **Paragraph 62: Link between stressed risk factors and the risk parameters**

Paragraph 62 stipulates application of supervisory guidance and additional benchmarks from external sources when establishing a link between stressed risk factors and the risk parameters. Institutions could benefit from the statistics on risk parameters for a financial industry as whole broken down to individual portfolios. In this respect, ESBG believes that the text could benefit from a clear recommendation to the competent authorities to publish such statistical data. If considered as more appropriate, amendment could also be done in the Supervisory stress testing section of a new draft SREP Guideline.

5. **Paragraph 83: Assessing the severity of scenarios**

Comparison with the reverse stress testing scenarios (paragraph 83) is recommended when assessing the appropriate degree of scenario severity. Although comparison of the reverse stress test scenarios with the regular stress test scenarios can be performed, limitations from this approach should be acknowledged. These limitations are stemming from a different purpose of reverse and regular stress testing: it is logical to expect more plausible scenarios in the regular stress testing exercise (as also stipulated by paragraph...
79) compared to reverse stress tests scenarios based on a pre-defined (extremely adverse) outcome. For this reason, ESBG would propose the following amendment of paragraph 83:

“When assessing the appropriate degree of severity of scenarios, institutions should also compare them with the scenarios outlined in their reverse stress testing, considering specific implications of the reverse stress test design on the scenario plausibility.”

6. Paragraph 188: Reliability of capital plans

Further to paragraph 188, any evaluation of the capital plan reliability under stressed conditions should take into consideration scenario severity and occurrence probability. In this regard, ESBG would like to stress that assessing planned capital requirements based on scenarios with extremely low probability of occurrence should be avoided.
About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 1,000 banks, which together employ 780,000 people driven to innovate at 56,000 outlets. ESBG members have total assets of €6.2 trillion, provide €500 billion in SME loans, and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking.